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IN THE

Supreme Court of the United States

OCTOBER TERM, 1960

No. 678

STATE-ADAMS CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent,

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit, entered in the above-entitled case on October 31, 1960.

Citations to Opinions Below

The findings of fact and opinion of The Tax Court printed in the Appendix hereto, p. 15, are reported in 32 T.C. 365. The opinion of the Court of Appeals for the Second Circuit, printed in the Appendix hereto, p. 39, is reported in 283 F.2d 395.

Jurisdiction

The decision of the Court of Appeals was rendered and its judgment entered on October 31, 1960. Appendix, p. 48. The jurisdiction of this Court is invoked under Section 1254(1) of the Judicial Code, 28 U.S.C., Section 1254(1).

Question Presented

The only question presented in this proceeding is whether the corporate entity of Petitioner, an Illinois real estate corporation, the sole purpose and function of which is passively to hold title to a single parcel of realty, is to be recognized for Federal income tax purposes, or whether, at the instance of the Petitioner, its separate entity should be disregarded and its income deemed to be in reality and substance the income of its stockholders.

Statute Involved

There is no statutory provision involved in this petition for certiorari.

Statement

This proceeding was initiated by a petition filed with The Tax Court to redetermine a deficiency in Federal income and excess profits taxes of the Petitioner, an Illinois real estate holding corporation, for the taxable year 1951. The deficiency resulted from the Commissioner's disallowing a deduction for so-called "interest" paid to Petitioner's note and stockholders in 1951. The Petitioner maintained in The Tax Court and in the Court of Appeals that, in view of its complete lack of corporate business activity or purpose, its corporate entity should be disregarded for Federal income tax purposes and that

its income was in reality and substance the income of its stockholders, taxable to them rather than to Petitioner. The Tax Court held that the Petitioner's corporate entity should be disregarded for tax purposes and the Court of Appeals reversed.

The Petitioner, State-Adams Corporation, was incorporated under the laws of Illinois on September 26, 1933, for the sole purpose of holding title to certain land on the corner of State and Adams Streets in Chicago, Illinois ("State-Adams property") (App. R. 167, 187).[1] Since May 1, 1915 this State-Adams property has been leased, under a net lease, to a Chicago department store known as "The Fair." Prior to the organization of Petitioner, the State-Adams property was owned by Mrs. Frances Sheldon Whitehouse (Mrs. Whitehouse) as sole trustee under the will of Edwin H. Sheldon who died in 1890. Mrs. Whitehouse also was sole income beneficiary of the Sheldon trust. Pursuant to the terms of the trust the State-Adams property was distributable on Mrs. Whitehouse's death to her descendants *per stirpes* (App. R. 168-69, 176).

In 1933 Mrs. Whitehouse was 81 years of age and had six children and several minor grandchildren. Two of her children were nonresident aliens who would have been prohibited under the applicable law of Illinois from holding title to Illinois real estate for a period in excess of six years. Had she died at such time the Sheldon trust automatically would have terminated and its assets, including the State-Adams property together with The Fair lease, would have been distributed in fee to her children, including the two nonresident aliens. If one of her children had predeceased her leaving minor issue,

[1] The statement of facts is taken from The Tax Court's findings of fact. App. R. references are to portions of the record printed for the use of the Court of Appeals in the appendices to the parties' briefs below.

an undivided interest in the State-Adams property would have vested in such minor issue on Mrs. Whitehouse's subsequent death (App. R. 170). To avoid these difficulties, the Whitehouse family attorney incorporated the Petitioner, and Mrs. Whitehouse, as trustee of the Sheldon trust, transferred title to the State-Adams property to Petitioner in return for all of its capital stock. The Fair lease was transferred to the Petitioner in exchange for its promissory note payable to Mrs. Whitehouse, as trustee, the "interest" on the note being equivalent to the amount of rent received from The Fair. At the time of Petitioner's incorporation, Mrs. Whitehouse was advised by her attorney that the "new arrangement" would in no way affect the present crediting of her account "with a sum equal to the total rent from the property" and that the arrangement was "really one of convenience and form only, and in no way prejudiced the interests of the remaindermen in the trust property" (App. R. 172-73).

Before the Petitioner's incorporation the rental income from The Fair was transmitted to the Bank of Montreal, New York, which credited the funds to Mrs. Whitehouse's account as trustee. After Petitioner's incorporation, the rental checks continued to be transmitted by The Fair directly to the Bank of Montreal which credited the funds to Mrs. Whitehouse's account. Thus, at no time was the rental income received or disbursed by the Petitioner (App. R. 175).

The so-called "interest" payments on the Petitioner's note were intended to exhaust the entire rental income and accordingly the interest rate on Petitioner's note was occasionally increased. Moreover, at times the amount paid out as "interest" exceeded the amount called for by the interest rate then prescribed by the note (App. R. 180).

The Fair lease under which the rental payments were made was a "net lease" under which all the duties of ownership and management were imposed upon the lessee. As a result, Mrs. Whitehouse, as trustee, and subsequently the Petitioner, as owners of the fee, were relieved of all managerial duties and the burdens of ownership with respect to the State-Adams property (App. R. 169).

The Petitioner did not at any time maintain an office (other than the required Illinois statutory office) for the transaction of business. It had no bank account. Its mailing address was at all times in care of the attorneys for the Whitehouse family. Thus, it had no expenses except the service fee charged by the Bank of Montreal (which was deducted by the Bank of Montreal from the rental before such rental was credited to the accounts of the remaindermen of the trust property), small legal fees paid to the Whitehouse family attorneys and Illinois franchise taxes. Payment of the aforesaid legal fees and franchise taxes also was made by the Bank of Montreal rather than by Petitioner (App. R. 174-75, 181).

At no time did Petitioner engage in any activity other than the passive holding of title to the State-Adams property. In each of its Federal income tax returns from the date of its organization to the present, Petitioner reported the rental payments from The Fair as its only income and deducted the expenses referred to above and "interest payments" from such income. In no instance did it report any net taxable income or pay any Federal income tax (App. R. 184).

Reasons for the Granting of the Writ

1. The Decision of the Court of Appeals Is in Conflict With the Decision of This Court in *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436 (1943).

This Court in *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436 (1943), clearly stated the test to be applied in determining whether a corporation is to be treated as a separate entity for tax purposes or its entity disregarded. In that case it was stated that a corporation will be regarded as a separate taxable entity so long as (1) the purpose of its incorporation "is the equivalent of business activity," or (2) its incorporation "is followed by the carrying on of business by the corporation." The rule of the *Moline* case has not been modified by this Court since its original promulgation.

Approximately one year after this Court's decision in the *Moline* case the rule which it laid down was succinctly interpreted by Judge Learned Hand in *National Investors Corp.* v. *Hoey*, 144 F.2d 466 (2d Cir. 1944). In order for a corporation to be regarded as a separate taxable entity within the meaning of the *Moline* decision, said Judge Hand,

> [it] must engage in some industrial, commercial or other activity . . . in other words, that the term "corporation" will be interpreted to mean a corporation which does some "business" in the ordinary meaning. . . .[2]

More recently, in *Jackson* v. *Commissioner*, 213 F.2d 289 (2d Cir. 1956), the rule laid down by this Court in the

[2] 144 F.2d at 468.

Moline case again was interpreted in the following language:

> A corporation may not be disregarded in respect of taxation if, *inter alia*, a bona fide intention in creating it was that the corporation itself should have some real substantial business function, or if it actually engages in business; on the other hand, the corporation may be disregarded, in the absence of such an intention or activity. The intended or actual business functioning of the corporation itself, not the taxpayer's aim to be accomplished via the corporation, is the test. [Footnotes omitted.]

The Tax Court in holding that the corporate entity of the Petitioner should be disregarded for Federal tax purposes applied the doctrine of the *Moline* case as above interpreted.

The Court of Appeals, however, in reversing The Tax Court in this case, held that so long as a corporation fulfills the purpose for which it was organized that is sufficient to constitute it a separate entity for Federal tax purposes. In this connection the Court of Appeals stated:

> Thus the Corporation was organized for a specific purpose which required for its fulfillment a separate legal entity, more than a sham or "shell"; and over the years it carefully satisfied every legal requirement to achieve its purpose.[3]

In essence the Court of Appeals held that so long as a purpose exists for incorporation and the corporation fulfills that purpose, the resulting entity is to be considered taxable irrespective of whether the purpose of incorporation is the equivalent of "business activity" and regardless of whether the fulfillment of such purpose necessitates the carrying on of business. This holding is directly in

[3] 283 F.2d at 398. "Respondent, organized to hold the title to the land and the lease, did not engage in general activities unconnected with this purpose." 283 F.2d at 397.

conflict with the doctrine laid down by this Court in the *Moline* case.

The *Moline* decision clearly establishes that not only must there be a purpose underlying the incorporation but such purpose must be "the equivalent of business activity." If the law were as stated by the Court of Appeals there would be no instance in which a corporate entity could be disregarded for tax purposes either by the Commissioner or the taxpayer. Every corporation perforce has a purpose underlying its organization and every corporation, unless immediately abandoned, fulfills the purpose for which incorporated. From this, however, it does not follow that every corporation is to be viewed as a separate entity for tax purposes. This proposition clearly was recognized by this Court in the *Moline* case. There, a definite purpose dictated the incorporation of the taxpayer corporation and such purpose admittedly was fulfilled. That fact, however, was not regarded as sufficient, in and of itself, by the Court to require recognition of the corporate entity. Rather, it was felt necessary to inquire into the nature of the purpose underlying the Moline Corporation's organization and into the type and extent of the activities undertaken in fulfillment of the corporate purpose. By making that inquiry the Court applied its rule, hereinbefore referred to, to the effect that recognition would be accorded the corporate entity where the purpose underlying the incorporation was "the equivalent of business activity" or where the incorporation was followed in fact by business activity. In other words, the essential point of inquiry in such cases was held to be the intended or actual business functioning of the corporation rather than the objective sought to be accomplished by its incorporators.

Clearly, therefore, by holding that the existence of a purpose for the Petitioner's incorporation, which purpose

was accomplished by the fact of its incorporation, was sufficient to constitute it a separate taxable entity, irrespective of whether such purpose of incorporation was "the equivalent of business activity," the Court of Appeals' decision is in direct conflict with this Court's decision in the *Moline* case.

It is well recognized that in the body of tax law pertaining to the recognition or non-recognition of the corporate entity this Court's decision in *Moline Properties, Inc.* v. *Commissioner, supra*, is regarded as a landmark. The decision has been cited and its doctrine applied in a myriad of cases since 1943. A consistent and correct interpretation of the rule which it laid down is essential both for the protection of the Federal revenue and the taxpaying public. The decision of the Court of Appeals in the instant case unquestionably renders uncertain the scope and effect of the doctrine laid down by this Court in the *Moline* decision. Such uncertainty should be resolved and the principle of the *Moline* case either clearly reaffirmed or modified by this Court.

2. The Decision of the Court of Appeals Is in Conflict With the Decision of the Court of Appeals for the Fourth Circuit in *United States* v. *Brager Bldg. & Land Corp.*, 124 F 2d 349 (1941).

The decision of the Court of Appeals in this case conflicts with the decision of the Court of Appeals for the Fourth Circuit in *United States* v. *Brager Bldg. & Land Corp.*, 124 F.2d 349 (1941), in that the decision below clearly indicates that a corporate entity will not be disregarded for tax purposes at the instance of a taxpayer even though it may be disregarded upon the request of the

Commissioner of Internal Revenue. In this connection the Court of Appeals stated:

> Furthermore, it is to be noted that in Jackson, as in O'Neill and most of the other cases cited, the corporate entity was disregarded at the instance of the Commissioner. As is shown by this Court's decision in Gregg Co. of Del. *v.* C.I.R., 2 Cir., 239 F.2d 498, certiorari denied 353 U.S. 946, 77 S.Ct. 825, 1 L.Ed. 2d 856, made soon after Jackson, the Commissioner, to prevent unfair tax avoidance, has greater freedom and responsibility to disregard the corporate entity than a taxpayer, who normally cannot be heard to complain that a corporation which he has created, and which has served his purpose well, is a sham.[4]

The fact that the court below regarded the right to urge that the corporate entity be disregarded as a "one-way street" open only to the Commissioner is further indicated by the fact that in discussing the cases of *Moline Properties, Inc.* v. *Commissioner*, *supra*, and *National Investors Corp.* v. *Hoey*, 144 F.2d 466 (2d Cir. 1944), it concluded by commenting that "it may be noted that in both cases decision went against the taxpayer." Moreover, the court specifically stated that "when Congress has desired to give taxpayers the benefit of using the corporate form without paying a corporate income tax, it has known how to do so specifically and directly." [Citing Subchapter S, I.R.C. 1954, §§1371-77].

The effect of the Court of Appeals' decision below is to preclude a taxpayer from arguing that a corporation organized by him can ever be disregarded for Federal tax purposes. *Higgins* v. *Smith*, 308 U.S. 473 (1940), does not stand for this proposition. The same argument was made to the Fourth Circuit in *United States* v. *Brager*

[4] 283 F.2d at 398-99.

Bldg. & Land Corp., 124 F.2d 349 (1941), decided after *Higgins* v. *Smith*. The Commissioner argued there that the taxpayer was estopped from asserting that a corporation of his creation was not a taxable entity. In disposing of the Commissioner's argument the court stated that:

> [I]t is going too far to say that if a taxpayer forms a corporation for his convenience, he is thereafter estopped from disclosing the true nature of the arrangement, whenever it is of advantage to the government to recognize only the corporate form. The advantage of the taxpayer has been served by many decisions in which the identity of the corporation and its sole stockholder has been adjudicated, and we do not understand that this body of the law has now for practical purposes ceased to exist. In a number of these cases, some of them decided after Higgins v. Smith, under circumstances quite similar to those found in the case at bar, it has been held that when a corporation has been formed merely as an agency to hold title to real estate for the convenience of the owner, and has served this purpose with little or no independent activity on its part, the property and the income therefrom should be regarded as belonging to the stockholder. See 112 W. 59th St. Corp. v. Helvering, 62 App. D.C. 350, 68 F.2d 397; North Jersey Title Ins. Co. v. Commissioner, 3 Cir., 84 F.2d 898; Mayer v. Commissioner, 36 B.T.A. 117; Carling Holding Co. v. Commissioner, 41 B.T.A. 493; Watson v. Commissioner, 1940, 42 B.T.A. 52; Cf. McDonald v. Commissioner, 4 Cir., 52 F.2d 920; Regals Realty Co. v. Commissioner, 1940, 43 B.T.A. 194; Lyon, Inc. v. Commissioner, 1940, 42 B.T.A. 1094.

Thus the Fourth Circuit specifically and unequivocally has rejected the theory advanced by the Court of Appeals below in the instant proceeding. Accordingly a clear con-

flict between the Court of Appeals for the Fourth Circuit and the Court of Appeals for the Second Circuit exists in this connection.

The decision of this Court in the *Moline* case, which was decided three years after *Higgins* v. *Smith*, *supra*, also stands for the proposition that a taxpayer as well as the Commissioner may, in a proper case, urge that a corporate entity should not be recognized for Federal tax purposes. If it were the exclusive privilege of the Commissioner so to argue, this Court in the *Moline* case obviously would have rested its decision on that single simple ground rather than troubling, as it did, to examine the activities carried on by the Moline Corporation and to rest its decision on the extent of such activities.

Since this Court's decision in *Higgins* v. *Smith*, *supra*, the Commissioner of Internal Revenue frequently has urged that a corporate entity may not be disregarded at the instance of the taxpayer who created it. Conflicting decisions upon this point such as the Fourth Circuit's opinion in the *Brager Bldg. & Land Corp.* case, *supra*, and the Second Circuit's holding below in the instant case serve to render even more uncertain an already beclouded area of the Federal tax law. Irrespective of the equities or merits of a rule which would operate only in favor of the taxing authorities, it is submitted that a definite ruling on this point by this Court now is dictated.

3. Under the Unique Circumstances of This Case the Decision of the Court of Appeals Below Results in Confiscatory Taxation Not Contemplated by Congress.

The Petitioner does not urge that the certiorari jurisdiction of this Court should be invoked solely for the purpose of reversing an incorrect decision of a Court of

Appeals. It is submitted, however, that such jurisdiction may, and indeed should, be taken where the failure to do so would be to sanction, without review, a lower court's decision which results in an exaction of tax far beyond that contemplated by our Internal Revenue laws. Such is the effect of the decision of the Court of Appeals below.

Since the inception of the Federal income tax, Congress consistently has recognized that dividends are to be taxed to a corporation's shareholders only to the extent that they are paid from the corporation's current or accumulated earnings and profits. Similarly, the earnings and profits of the payor corporation are those profits remaining after the payment of proper corporate expenses and charges, including taxes. Thus, a corporation having a net income before Federal taxes of $100,000 and a tax liability of $50,000 is left only with $50,000 to distribute as taxable dividend income to its stockholders.

In the present case the Petitioner consistently, for a period of twenty-one years following its organization, reported the receipt of the rental income from The Fair and deducted the entire amount thereof (less negligible fees and charges) as "interest" paid to its noteholders. In turn, in each of the years over this period, the noteholders included the entire amount of such "interest" received by them in their gross income for Federal income tax purposes. As a result of the decision of the Court of Appeals below, these so-called "interest" payments to the Petitioner's noteholders now are taxable to them as "dividends." Accordingly, had these payments consistently been treated as "dividends" rather than "interest" the Petitioner's noteholders would have been taxed only upon approximately 48% of the rental income rather than 100%.

Although the taxable year 1951 was the only taxable year before The Tax Court and the Court of Appeals, all

subsequent years to and including the taxable year 1960 are either open under the applicable Statute of Limitations or under waivers thereof. Accordingly, if the decision of the Court of Appeals stands the Petitioner will be liable for deficiencies in respect of each of the taxable years 1951-1960 inclusive. Irrespective of this fact its noteholders still will have been required to pay tax upon 100% of the Petitioner's income. Nor may any relief be obtained by such noteholders through the filing of claims for refund, at least in respect to years prior to 1958, inasmuch as such claims now are barred by the Statute of Limitations. As a result, the Government will receive approximately 52%, plus applicable interest, of the Petitioner's gross income for 1951 and subsequent years and still will retain the taxes paid by its noteholders upon 100% of such income.

The Petitioner does not argue that the result just outlined constitutes a ground for reversal of the decision below. Rather it argues that such a result should not in good conscience and equity be allowed without the decision of the court below first being scrutinized by our court of highest jurisdiction.

Conclusion

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

H. Gilmer Wells,
Attorney for the Petitioner.

Jacquelin A. Swords,
Arnold J. Zurcher, Jr.,
Of Counsel.

Dated: New York, N. Y., January 26, 1961.

APPENDIX

Opinion of The Tax Court

STATE-ADAMS CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 63473. Filed May 15, 1959.

In order to obviate anticipated difficulties with regard to the devolution of title to a valuable piece of Chicago real estate leased on a long-term "net lease" to a department store, petitioner corporation was organized to hold title to such real estate (and lease). It was not intended that petitioner would exercise any substantial business function with regard to this property or otherwise, and petitioner did not actually engage in business after its organization. Its only activities were the holding of title to such real estate, the taking of steps necessary to continue its own corporate life, and the substantial continuation of those methods by which the income from the property was remitted to the beneficial owners thereof. *Held*, income from such property not taxable to petitioner. *John A. Mulligan*, 16 T.C. 1489, followed.

H. GILMER WELLS, Esq., and ALBERT C. PETITE, Esq., for petitioner.

WILLIAM T. HOLLORAN, Esq., and PAUL D. BARKER, Esq., for the respondent.

Respondent determined a deficiency in petitioner's Federal income and excess profits tax for the year 1951 in the sum of $88,558.18. Respondent explained this determination as follows:

> It is held that the lease of property located at State and Adams Streets, Chicago, Illinois, under which, The Fair, an Illinois corporation, is the lessee, which was transferred to you by your stockholder in 1933 for a note of $2,700,000.00 with interest at 5% per annum, represents a contribution to capital and the alleged interest payments of $139,015.68 thereon are not deductible under the provisions of Section 23(b) of the Internal Revenue Code of 1939.

Petitioner alleged in its petition that respondent erred in his determination that the interest payments were not deductible under section 23 (b) of the Internal Revenue Code of 1939, and, in the alternative, that respondent "erred in failing and refusing to determine that the Petitioner is, and was during the period herein involved, a mere conduit or agency formed and utilized for the sole purpose of holding title to real estate and therefore is not to be regarded as a separate taxable entity distinct from its stockholders."

Petitioner also alleged error in that respondent refused "to determine that the Petitioner was entitled to compute its 1951 excess profits credit by the method prescribed by Section 435 or 436 of the Internal Revenue Code of 1939." No mention was made of this alleged error at the trial herein or on brief and we assume that it has been waived by petitioner.

The testimony adduced by petitioner at the trial herein related only "to disregarding the petitioner as a separate taxable entity" and petitioner's argument on brief was confined to its contention that "petitioner is not a taxable entity separate and distinct from its stockholders."

Findings of Fact.

Most of the relevant facts herein were the subject of a stipulation by the parties. All facts so stipulated and the exhibits attached thereto are made a part of our findings by this reference.

Petitioner State-Adams Corporation, hereinafter sometimes referred to as "petitioner," was incorporated under the laws of Illinois on September 26, 1933. At all times relevant to this proceeding, with exceptions to be noted hereinafter, petitioner was and is so incorporated. Its address is c/o John N. Penick, 30 Broad Street, New York 4, New York. It filed a corporation income tax return for the taxable year 1951 with the collector of internal revenue for the second district of New York, listing its principal business activity as "Real Estate Holding." In this return it reported the receipt of rent in the sum of $140,000, deducted therefrom the sums of $139,015.68 in "interest" and $984.32 as "Legal services and collection charges," and reported its net income as "none." In Schedule E the return stated: "The Corporation owns title to property on the corner of State and Adams Streets, Chicago. It receives rent of $140,000 annually, and disburses the same, less legal fees and collection charges to the holders of the corporation promissory notes in payment of interest on the notes." In

Schedule M the return stated: "THIS CORPORATION HAS NO NET INCOME, NO EARNED SURPLUS AND NO UNDIVIDED PROFITS."

A consent, Form No. 872, extending to June 30, 1956, the period of limitation for assessment of income taxes with respect to petitioner's taxable year 1951 was executed on February 24, 1955, on behalf of petitioner and respondent.

Edwin H. Sheldon died testate a resident of Delaware County, New York, on December 18, 1890, leaving a will dated May 27, 1887, which was duly admitted to probate by the Surrogate's Court of Delaware County, New York, on January 10, 1891. Letters Testamentary were duly issued to Edwin B. Sheldon and Frances Sheldon Whitehouse, the surviving son and daughter, respectively, of Edwin H. Sheldon. By his will, Edwin H. Sheldon, devised and bequeathed his residuary estate in trust, hereinafter referred to as the "Sheldon Trust," naming Edwin B. Sheldon and Frances Sheldon Whitehouse as trustees. The terms of the Sheldon Trust provided that after the payment of certain annuities the net income therefrom was to be divided equally between Edwin B. Sheldon and Frances Sheldon Whitehouse during their joint lives. Upon the death of either, his or her share was to pass to his or her descendants, *per stirpes*, and in default of such descendants, the survivor of Edwin B. Sheldon or Frances Sheldon Whitehouse was to receive the entire trust income for life and upon his or her death the entire trust property was to be transferred and paid over in fee to his or her descendants, *per stirpes*.

The assets in the Sheldon Trust included a parcel of real property located at the corner of State and Adams

Streets, Chicago, Illinois, hereinafter sometimes referred to as "State-Adams property." Under date of May 1, 1915, this State-Adams property was leased by Edwin B. Sheldon and Frances Sheldon Whitehouse, in their capacity as trustees of the Sheldon Trust, to a Chicago department store know as and hereinafter referred to as "The Fair." The Fair lease was for a term of 79 years, commencing May 1, 1915, and ending April 30, 1994, and provided for lease rentals in the following amounts:

1 May, 1915		Annual	Monthly
to "	1920	$125,000	$10,416.67
" "	1925	130,000	10,833.34
" "	1930	132,500	11,041.67
" "	1950	135,000	11,250.00
" "	1994	140,000	11,666.67

This lease still is in full force and effect and has not been the subject of modification in any respect since its execution on May 1, 1915.

The lease to The Fair of the State-Adams property was a "net lease." Pursuant to its terms all of the usual duties of ownership and management with respect to the property and any improvements thereon were imposed upon The Fair as lessee. The lessee had the duties of paying all water rates, taxes, general and special assessments, and all other impositions of every kind or nature levied or assessed upon the premises or upon any buildings or improvements at any time situated thereon. The lessee was required to see that the premises and improvements thereon were devoted to lawful uses, to maintain the premises and the improvements, and to keep them

adequately insured. As a result of these provisions of the lease, Edwin B. Sheldon and Frances Sheldon Whitehouse, the owners of the fee as trustees, were relieved of all managerial duties and the normal burdens of ownership with respect to the State-Adams property.

In 1923 Edwin B. Sheldon died without descendants, leaving Frances Sheldon Whitehouse as the sole trustee and sole income beneficiary of the Sheldon Trust. At this time Frances Sheldon Whitehouse had six children, namely, Henry J., William FitzHugh, Sheldon, Norman O., Frances Ramsay, and Lily Coventry.

Between 1923 and 1933 two of Frances Sheldon Whitehouse's children, Frances Ramsay and Lily Coventry, married nonresident aliens and each relinquished her American citizenship. These daughters and three of Frances Sheldon Whitehouse's sons, Henry, William, and Sheldon, all had children of their own. By 1933 Frances Sheldon Whitehouse was 81 years of age. Several of her grandchildren were then minors. Had she died at such time the Sheldon Trust automatically would have terminated and its assets, including the State-Adams property together with The Fair lease, would have been distributed in fee to Frances Sheldon Whitehouse's six children, including the two who were nonresident aliens. If one of her children had predeceased her leaving minor issue, an undivided interest in the State-Adams property would have vested in such minor issue on Frances Sheldon Whitehouse's subsequent death.

By 1933 Frances Sheldon Whitehouse had become concerned about the devolution of ownership of the State-Adams property upon the termination of the Sheldon

Trust at her death. This concern was particularly acute in view of the fact that the laws of the State of Illinois (Section 2 of the Illinois Session Laws of 1897) then in force prohibited the ownership of Illinois real estate by aliens for a period in excess of 6 years and, as matters then stood, Frances Sheldon Whitehouse's two daughters, Frances Ramsay and Lily Coventry, both aliens, would have received title to undivided interests in the State-Adams property upon the death of Frances Sheldon Whitehouse. A further cause for concern was the probability that difficulties might arise in connection with title in the event that part of the ownership of the State-Adams property vested in minor beneficiaries upon the termination of the Sheldon Trust.

Early in 1933 Frances Sheldon Whitehouse's attorney in New York, Charles E. Smith, was consulted concerning these problems and requested to devise a solution. On May 24, 1933, Smith wrote Russell F. Locke, a Chicago attorney, outlining his problem as follows:

> It is possible that in the not-distant-future I shall be confronted with the problem of holding title to a piece of Chicago real estate for the benefit of half a dozen individuals who will be the actual owners. By reason of the fact that all of these individuals are married, most have children, and several are non-residents of the United States, you can readily see the desirability of having the legal title elsewhere than in all six jointly.
>
> In our enlightened State this problem would be readily solved by the use of a real estate holding corporation, but in the sovereign State of Illinois (where, I understand, trial by battle and ordeal by

> fire still are practiced), I am informed that real estate holding corporations are not permitted.
>
> Without devoting any time to the question, I wonder if you would give me your idea of what might be done. I suppose title might be conveyed to a bank and held by it under a deed of trust. Perhaps your ingenious mind has devised some other scheme for avoiding title difficulties in a case of this sort, without interfering with the beneficial interest of the various individuals.

Subsequently Smith and Locke developed a plan whereunder Frances Sheldon Whitehouse, as trustee and life beneficiary of the Sheldon Trust, would convey the title to the State-Adams property and The Fair lease to an Illinois corporation in exchange for its securities so that upon her death the remaindermen of the trust would receive securities of the corporation. On June 10, 1933, Smith again wrote Locke confirming this plan, this letter reading in pertinent part as follows:

> As I have stated in my previous letters, the plan is to have Mrs. Whitehouse, as Trustee and life beneficiary, to convey the title to an Illinois corporation, and upon her death the remaindermen, those of her children who survive her, would receive securities of the corporation without the title of the property being in any way affected.
>
> You will see from the foregoing that the arrangement is really one of convenience and form only, and in no way prejudices the interests of the remaindermen in the trust property.

All of the subscribers named in the Certificate of Incorporation of petitioner were associates in Locke's law office

in Chicago, and Locke was named as the registered agent of the corporation. The purpose for which the petitioner was organized, as set forth in its Certificate of Incorporation, was to "purchase, own, hold title to and sell real estate in the State of Illinois." At all times since its incorporation and relevant hereto the only assets of petitioner consisted of the State-Adams property and the long-term lease thereof to The Fair.

On September 29, 1933, Smith wrote Frances Sheldon Whitehouse, who was then in Paris, France, advising her of the formation of the State-Adams Corporation and requesting that she execute a deed to the State-Adams property and an assignment of The Fair lease, both running to petitioner. Smith informed Frances Sheldon Whitehouse that the deed would be delivered to petitioner in return for all of its capital stock and that the assignment of the lease would be delivered to it in return for its promissory note payable to Frances Sheldon Whitehouse as trustee, the interest on which note would "be equivalent to the amount of the rent received from The Fair." Smith also advised Frances Sheldon Whitehouse that the "new arrangement" would in no way affect the present crediting of her account "with a sum equal to the total rent from the property."

At the first organizational meeting of stockholders and directors, held in Smith's offices in New York City, on October 27, 1933, the State-Adams real property was conveyed to petitioner by Frances Sheldon Whitehouse, as trustee, in exchange for all of petitioner's capital stock, namely, 100 shares of the par value of $100 each. At the same board of directors' meeting Frances Sheldon White-

house, as trustee, assigned to the petitioner the leasehold agreement dated May 1, 1915, whereunder the State-Adams property was leased to The Fair until April 30, 1994.

At the time of the assignment to petitioner of the lease petitioner made and delivered to Frances Sheldon Whitehouse, as trustee, its promissory note dated November 1, 1933, in the amount of $2,700,000 bearing interest at the rate of 5 per cent per annum, payable monthly in advance. The 5 per cent interest rate would yield $135,000 per annum, the exact amount of the annual rental then being received under The Fair lease. The note dated November 1, 1933, was payable 3 years after date. No cash was paid into the petitioner upon its organization.

At the time of incorporation of petitioner, Frances Sheldon Whitehouse, her son William FitzHugh Whitehouse, Smith, and Locke were elected as directors. Frances Sheldon Whitehouse was elected president, William FitzHugh Whitehouse vice president and treasurer, and Smith secretary. The Bank of Montreal, Chicago branch, was selected as the Illinois statutory office, and the petitioner's mailing address was designated as "care of Mr. Charles F. Smith, of New York City, N. Y." Smith was also attorney for Frances Sheldon Whitehouse. Upon Smith's death in 1950, petitioner's mailing address was changed to "care of one of Mr. Smith's law partners, Mr. John N. Penick," who after Smith's death became the attorney for the Whitehouse family.

At the initial meeting of petitioner's subscribers held in Smith's office on October 27, 1933, and attended only by Smith and William FitzHugh Whitehouse, petitioner's bylaws, consisting of 2¼ typewritten pages, were adopted. The bylaws provided that petitioner's board of directors

should consist of four directors, only two of which would be necessary to constitute a quorum.

Before the organization of petitioner, the rental income from the State-Adams property receivable by Frances Sheldon Whitehouse, as trustee, from The Fair was forwarded directly by The Fair to Ogden, Sheldon & Co., a Chicago real estate concern, which, after deducting a commission of 1 per cent, transmitted the proceeds to the Bank of Montreal, New York, which credited the funds to the "Income Account of the Estate of Edwin H. Sheldon, deceased (Mrs. Frances S. Whitehouse, Trustee)."

The Bank of Montreal has always been the bank used by the Whitehouse family. Immediately after the organization of the petitioner, The Fair was instructed by petitioner, acting according to corporate resolutions, to deliver the rental checks to the Bank of Montreal, Chicago, Illinois. The Chicago branch of the Bank of Montreal in turn cleared the checks and was instructed to remit the funds received from The Fair to the "Agents, Bank of Montreal, New York, for the credit of Frances Sheldon Whitehouse, as surviving trustee of the E. H. Sheldon Estate." At no time after the organization of petitioner were any rental payments made directly to it. All rental payments were made by The Fair directly to the Bank of Montreal by checks payable to petitioner. Petitioner never maintained a bank account and no check was ever drawn in its name on any account.

In January of 1938 Locke and Smith discovered that approximately 2½ years earlier petitioner, at the instance of the Secretary of State of Illinois, had been dissolved on July 2, 1935, by order of the Superior Court of Cook County, Illinois, as a result of its failure to file Illinois

franchise tax returns and to pay such taxes. In March of 1938 petitioner's delinquent Illinois franchise taxes were paid by Smith and an order was then entered vacating the 1935 decree of dissolution.

The note dated November 1, 1933, which was due on November 1, 1936, was not paid by petitioner in 1936 nor was it presented for payment. However, "interest" continued to be paid thereon. In April of 1940 a new note dated April 1, 1940, payable April 1, 1943, for $2,700,000 with interest at 5 per cent was issued.

Frances Sheldon Whitehouse died on March 7, 1944, and, pursuant to its terms, the Sheldon Trust terminated. The trust principal, including the stock and promissory note of petitioner, thereupon vested in the remaindermen who then were Frances Sheldon Whitehouse's four surviving sons, her daughter Lily Coventry, and the two children of Frances Ramsay, Frances Sheldon Whitehouse's deceased daughter who had died in 1935. At this time Lily Coventry and the two surviving children of Frances Ramsay were nonresident aliens of the United States. Each of Frances Sheldon Whitehouse's five surviving children was entitled to a one-sixth interest and the two grandchildren each to a one-twelfth interest in the trust estate. Accordingly, the 100 shares of petitioner's stock theretofore held by the Sheldon Trust were distributed and transferred as follows:

Children of Frances S. Whitehouse	Number of Shares	Remainder Interest
Henry J. Whitehouse	16 2/3	1/6
William F. Whitehouse	16 2/3	1/6
Sheldon Whitehouse	16 2/3	1/6
Norman O. Whitehouse	16 2/3	1/6
Lily Coventry	16 2/3	1/6

Grandchildren of Frances S. Whitehouse		
Veronica Armfelt (now Ward)	8 1/3	1/12
Constantine A. F. Ramsay	8 1/3	1/12

To effect this distribution the certificate for 100 shares of petitioner's stock formerly held by the Sheldon Trust was canceled and new certificates issued to the children and grandchildren of Frances Sheldon Whitehouse as indicated above.

The distribution and transfer of petitioner's stock to the remaindermen of the Sheldon Trust were effected at a meeting of the directors of petitioner held in Smith's office in New York on March 17, 1944, shortly after Frances Sheldon Whitehouse's death. William FitzHugh Whitehouse and Smith were the only attendants of this meeting. At this meeting Smith recommended that petitioner's promissory note in the amount of $2,700,000, formerly held by the Sheldon Trust and vested in the trust remaindermen since Frances Sheldon Whitehouse's death, be written down to the amount of $1,682,500 which would more closely approximate the then fair market value of the State-Adams property. Smith pointed out that inasmuch as the same persons owned petitioner's stock and its note in exactly the same proportions, revision of the amount of the note would therefore make no change in the actual total value of the stock and note to any of the holders. The amount of petitioner's promissory note was accordingly adjusted to $1,682,500. The 5 per cent promissory note in the principal amount of $2,700,000, formerly held by the Sheldon Trust, was surrendered for cancellation and new notes aggregating $1,682,499.96, dated April

1, 1944, and bearing interest at the rate of 8 per cent per annum "or an amount equal to 1/6[1] of the maker's net earnings, whichever is lower," were issued to the trust remaindermen as follows:

Children of Frances S. Whitehouse	Face Amount of Note	Remainder Interest
Henry J. Whitehouse	$280,416.66	1/6
William F. Whitehouse	280,416.66	1/6
Sheldon Whitehouse	280,416.66	1/6
Norman O. Whitehouse	280,416.66	1/6
Lily Coventry	280,416.66	1/6
Grandchildren of Frances S. Whitehouse		
Veronica Armfelt (now Ward)	140,208.33	1/12
Constantine A. F. Ramsay	140,208.33	1/12

Immediately after the death of Frances Sheldon Whitehouse in March of 1944, the Bank of Montreal in Chicago was instructed by petitioner, acting according to corporate resolutions, to continue to 'receive' the rental checks from The Fair and to transmit the funds direct to the Bank of Montreal in New York City. The Bank of Montreal in New York City was in turn directed to deposit each remainderman's pro rata share of the rental directly to his or her personal account. It was agreed that as compensation for its services in this connection the Bank of Montreal would be entitled to withhold from the rental payments received by it a service fee of one-half of 1 per cent thereof before allocating the rental payments among the remaindermen of the Sheldon Trust. (These fees were deducted by petitioner each year in its income tax return.) From the time of petitioner's organization in 1933 until

[1] This fraction was 1/12 in the case of the notes issued to the grandchildren.

the closing of the Chicago branch of the Bank of Montreal in 1952, all rental payments made by The Fair under the lease of May 1, 1915, were paid by The Fair directly to the Chicago branch of the Bank of Montreal by checks payable to petitioner; after the closing of the Bank of Montreal's Chicago branch in 1952, all such payments were made by The Fair to The First National Bank of Chicago, Chicago correspondent for the Bank of Montreal, which credited such funds to the account of the Bank of Montreal, New York agency. After deducting its service fee therefrom the Bank of Montreal in New York credited each remainderman's pro rata share of such amounts directly to his or her personal account.

In April 1944, shortly after the death of Frances Sheldon Whitehouse, the Bank of Montreal in New York wrote Smith pointing out that since Frances Sheldon Whitehouse had died and as a result thereof the remaindermen of the Sheldon Trust had come into possession of the petitioner's stock and notes representing beneficial ownership and control of the State-Adams property, it felt "that for the sake of regularity of procedure" it should be furnished with a directive signed by all of the remaindermen, having "beneficial ownership and control of the Illinois realty," which would authorize the Bank of Montreal thereafter to continue to collect and dispose of the rentals as it had done in the past. The requested directive, signed by the remaindermen, was furnished the Bank of Montreal shortly thereafter.

In April 1946, Illinois counsel for The Fair wrote Smith advising him that they questioned petitioner's title to the State-Adams property and the validity of the 1933

assignment to petitioner by Frances Sheldon Whitehouse as trustee of The Fair lease. Accordingly, they requested quitclaim deeds and a ratification of The Fair lease from all of the remaindermen of the Sheldon Trust. The quitclaim deeds so requested were obtained by Smith and delivered to the representatives of The Fair in May and June 1946. The ratification of the lease was effected at a special meeting of petitioner's stockholders, called for this particular purpose, held in Smith's office on January 28, 1947.

It was the intention of the organizers of petitioner and subsequently of all remaindermen of the Sheldon Trust, who became the petitioner's stockholders and noteholders upon Frances Sheldon Whitehouse's death, to distribute pro rata among the beneficial owners of the State-Adams property the entire net rentals from the property irrespective of the interest rate prescribed by petitioner's promissory notes. Thus, upon several occasions the amount distributed to petitioner's noteholders actually exceeded the amount which would have been payable pursuant to the interest rate prescribed by petitioner's notes. In the taxable year 1951, $139,000 was distributed to petitioner's noteholders as "interest" while the amount required to be distributed by the 8 per cent interest rate prescribed in the notes would have been approximately $134,600.

Throughout the entire history of petitioner the rate of interest applicable to its promissory notes intentionally was fixed and adjusted so as to exhaust the aggregate net rental payments receivable from The Fair and thus to pass such rentals on to the beneficial owners of the prop-

erty (or their heirs) as such ownership existed prior to October 27, 1933. In 1954, by which time the rentals from The Fair had increased to $140,000 per annum, the interest rate on petitioner's notes was changed from 8 per cent per annum to the lower of 8½ per cent per annum or the company's net earnings. This last interest adjustment was effected at a special meeting of petitioner's board of directors held in its New York attorney's office on April 12, 1954. At this meeting it was pointed out that the adjustment in the prevailing interest rate was necessary since "in view of the present increased rental from The Fair, the 8% interest rate formerly charged did not exhaust all of the net earnings of the Corporation."

At no time since its organization has petitioner maintained an office (other than the required Illinois statutory office) for the transaction of business. Its mailing address at all times has been in care of Smith or John N. Penick, attorneys for the Whitehouse family.

The only expenses which petitioner sustained throughout the period of its existence consisted of the service fee charged by the Bank of Montreal, small legal fees payable to Smith's and Penick's law firm, and Illinois franchise taxes. These expenses were not paid directly by petitioner but were paid by Smith's and Penick's law firm which received reimbursement therefor from the Bank of Montreal, the Bank of Montreal deducting such expenses from the next rental check received by it from The Fair before effecting pro rata distribution of the net proceeds among the beneficial owners.

None of the officers or directors of petitioner, all of whom were either members of the Whitehouse family or

their counsel, received any compensation from petitioner in their capacity as officers or directors. Article III-3 of petitioner's by-laws, which was never amended in this respect, expressly provided that no compensation should be paid to the directors or officers of petitioner for any services rendered to petitioner in such capacities. In its Federal income tax returns for the years 1934 through 1943, deductions in amounts ranging from $350 to $610 were claimed under the heading of "Compensation of Officers." Such amounts actually represented Smith's compensation as attorney and the various charges and franchise taxes referred to above, and were deducted as follows:

Year	Amount	
1933	$2,250.00	Legal services for incorporation
1934	357.00	Compensating of officers (name not given), including $7.00 capital stock tax
1935	350.00	Compensation of officers (name not given)
1936	350.00	Compensation of officer, C. F. Smith, Secretary, with the following note: "Compensation covers general legal and secretarial work for the Company."
1937	350.00	Compensation of officer, C. F. Smith, Secretary, with the following note: "Compensation covers general legal and secretarial work for the Company."
1938	450.00	Compensation of C. F. Smith
1939	413.87	Compensation of C. F. Smith "and disbursements"
1940	410.00	Compensation of C. F. Smith "and disbursements"
1941	410.00	Compensation of C. F. Smith "and disbursements"
1942	610.00	Compensation of C. F. Smith "and disbursements"

Year	Amount	
1943	410.00	Compensation of C. F. Smith "and disbursements"
1944	2,569.77	"Legal service and collection charges"
1945	2,158.25	"Legal service and collection charges"
1946	2,000.00	"Legal service and collection charges"
1947	2,000.00	"Legal service and collection charges"
1948	1,000.00	"Legal service and collection charges"
1949 1950	N.A.	
1951	984.32	"Legal service and collection charges"

From the time of its organization to the present date only two meetings of petitioner's stockholders have been held. The first, held on October 27, 1933, was a meeting of the original subscribers which was necessary in order to comply with the legal requirements of corporate formation. The only other stockholders' meeting was held on January 28, 1947, for the sole purpose of ratifying The Fair lease, as requested by The Fair. Over the period from 1933 to the date of the trial herein ten directors' meetings of petitioner have been held. All of these meetings were held in Smith's or Penick's office. The directors' meetings, as recorded in the minute books of petitioner, were held on the following dates:

October 27, 1933
November 17, 1933
April 19, 1940
March 17, 1944
December 21, 1945
March 15, 1946
January 21, 1949
July 15, 1949
May 15, 1950
April 12, 1954

In each of its Federal income tax returns from the date of its organization to the present date, petitioner consistently has reported the rental payments from The Fair as its sole income and has deducted the expenses set out above and interest payments, said rental income and interest payments being as follows:

Years	Rental Income	Deduction Entitled "Interest Expense"
1933	$ 11,250	$ 11,250
1934	135,000	135,000
1935	135,000	135,000
1936	135,000	135,000
1937	135,000	135,000
1938	135,000	135,000
1939	135,000	134,586.13
1940	135,000	134,590
1941	135,000	134,590
1942	135,000	134,390
1943	135,000	134,590
1944	135,000	132,430.23
1945	135,000	132,841.75
1946	135,000	133,000
1947	135,000	133,000
1948	135,000	134,000
1951	140,000	139,015.68

In no instance has it reported any net taxable income or paid any Federal income taxes.

OPINION.—

KERN, *Judge:* The deficiency involved in this case results from the respondent's determination that the so-called interest payments here involved, although in form the payments of interest called for by promissory

notes, were, as a matter of economic reality and for Federal income tax purposes, the distributions of income to the investors of equity capital, and were therefore not deductible as interest under section 23 (b) of the Internal Revenue Code of 1939. The petitioner on brief does not contend that these payments constituted deductible payments of interest. Its argument is that respondent has not gone far enough in applying the doctrine that in Federal tax matters substance shall prevail over form, and that under the peculiar facts of this case that doctrine requires that the corporate entity of petitioner separate and apart from its shareholders be ignored and that the income which is in form that of the corporate petitioner should be considered as being, in reality and for Federal tax purposes, the income of its shareholders taxable to them and not to petitioner.

Upon the question of when and under what circumstances the corporate entity may be disregarded for Federal tax purposes, the law has been succinctly stated by the United States Court of Appeals for the Second Circuit in *Jackson* v. *Commissioner*, 233 F.2d 289, 290, affirming 24 T.C. 1, as follows:

> A corporation may not be disregarded in respect of taxation if, *inter alia*, a bona fide intention in creating it was that the corporation itself should have some real substantial business function,[1] or if it actually engages in business; on the other hand, the corporation may be disregarded, in the absence of such an intention or activity. The intended or actual business functioning of the corporation itself,

[1] [This footnote omitted as irrelevant.]

not the taxpayer's aim to be accomplished via the corporation, is the test.[2]

See also *Langdon L. Skarda*, 27 T.C. 137, 145, affd. 250 F.2d 429.

Examples of fact situations in which "a corporation may not be disregarded in respect of taxation" are found in *Estate of L. B. Whitfield*, 14 T.C. 776; *Langdon L. Skarda, supra; Harry F. Shannon*, 29 T.C. 702; and *Given* v. *Commissioner*, 238 F.2d 579 (affirming a Memorandum Opinion of this Court). Examples of fact situations in which a corporation may be so disregarded are found in *Paymer* v. *Commissioner*, 150 F.2d 334, and *John A. Mulligan*, 16 T.C. 1489. See also *The Bartell Hotel Co., Inc.*, 32 T.C. 311. Such fact situations in which the general rule (that a corporation should be considered for tax purposes as an entity separate and distinct from its stockholders) is not applicable are, in the examples given, where for the convenience of owners of real property[3] title to such property is transferred to and held by a corporation which thereafter does not itself engage in any business activity with regard thereto, such as mortgaging such property, executing leases, collecting rentals, making improvements, maintaining a bank account, or negotiating sales.

The facts in the instant case more closely resemble those present in *John A. Mulligan, supra*, than those of

[2] A natural person may be used to receive income which in fact is another's. So, too, a corporation, although for other purposes a jural entity distinct from its stockholders, may be used as a mere dummy to receive income which in fact is the income of the stockholders or of someone else; in such circumstances, the company will be disregarded.

[3] Including long-term leases. See *Lewis Eugene Grigsby Trust*, 5 T.C. 51.

any other case brought to our attention by the voluminous briefs filed by the parties. The only reason for the creation of petitioner corporation and the transfer to it of the real property (including the lease) was to convenience the owners of the property with regard to matters incident to the holding of title thereto. It was never intended that the corporation should, and the corporation did not perform any real substantial business function or engage in a business activity with regard to the property. It executed no leases, mortgages, or sales. It made no improvements or repairs, and paid no taxes on the property. It maintained no bank account and had no working capital. The rentals were collected by the same persons who collected them before the formation of petitioner and were credited to the checking accounts of the persons (or their heirs) owning the property prior to the passing of title to petitioner. The only things done by petitioner were to take steps necessary for the channeling of the income from the property to those owners (without itself receiving and depositing such income) and to take steps necessary for the preservation of its corporate life (and even this was in jeopardy for a period because of the carelessness of its officers with regard to its affairs). Petitioner did not exercise a substantial business function or actually engage in business after its creation by reason of acquiring the lease in return for the execution of its promissory notes. Respondent himself characterizes this transaction, and rightly so, as a contribution of capital with the notes evidencing equity ownership and a right to income rather than a debt.

Under the peculiar facts of this case we conclude that the corporate entity of petitioner should be disregarded for Federal tax purposes and that the income which is in form the income of petitioner is in reality the income of its stockholders and should be taxable to them rather than to petitioner.

Decision will be entered under Rule 50.

Opinion of the United States Court of Appeals for the Second Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

STATE-ADAMS CORPORATION,
Respondent.

No. 37, Docket 26100.

United States Court of Appeals
Second Circuit.

Argued Oct. 13, 1960.
Decided Oct. 31, 1960.

Kenneth E. Levin, Atty., Dept. of Justice, Washington, D. C. (Charles K. Rice, Asst. Atty. Gen., and Lee A. Jackson and Harry Baum, Attys., Dept. of Justice, Washington, D. C., on the brief), for petitioner.

H. Gilmer Wells, of Cadwalader, Wickersham & Taft, New York City (Arnold J. Zurcher, Jr., and Charles S. P. Barker, New York City, on the brief), for respondent.

Before CLARK, MAGRUDER, and FRIENDLY, Circuit Judges.

CLARK, Circuit Judge.

Petitioner asserted deficiencies amounting to $88,558.18 in the income and excess profit taxes due from respondent corporation for the year 1951. The Tax Court held that respondent was not a corporation for tax purposes and

therefore owed no tax. 32 T.C. 365. This petition for review followed.

In its corporate income tax return for 1951, respondent, following its practice since its incorporation in 1933, reported no net income. After reporting the receipt of rent in the sum of $140,000 respondent deducted $984.32 as "legal services and collection charges," and deducted the remaining $139,015.68 as "interest" paid on notes held by the shareholders. The Commissioner determined that this "interest" was in reality a dividend—a conclusion which respondent does not contest. But respondent argues that it was a mere dummy for the holding of title, and therefore its separate corporate existence should be disregarded for federal tax purposes.

Respondent was incorporated under the laws of Illinois on September 26, 1933, for the purpose of holding title to certain land at State and Adams Streets in Chicago. This "State-Adams" property was then owned by Mrs. Frances Sheldon Whitehouse as sole trustee of the "Sheldon Trust," of which she was sole income beneficiary. On Mrs. Whitehouse's death the land would be distributed to her descendants *per stirpes*. In 1933, Mrs. Whitehouse was 81 years of age and had six children and several minor grandchildren. Two of these children were aliens and were prohibited by Illinois law from owning real estate for more than six years. There was the further possibility that part of the ownership of the State-Adams property would become vested in minor beneficiaries. To avoid these difficulties which might arise on the death of Mrs. Whitehouse, the family attorney caused the incorporation of the respondent. Mrs. Whitehouse, as trustee of the Sheldon Trust, transferred title of the State-Adams

property to the new corporation in return for all its capital stock. At the time, the property had been leased to The Fair department store for a term of 79 years, at annual rentals which increased periodically from $125,000 for 1915-20 to $140,000 for 1950-94. This lease was transferred to respondent in exchange for its promissory note payable to Mrs. Whitehouse as trustee, the interest on the note being equivalent to the amount of rent received from The Fair. At the time of incorporation, Mrs. Whitehouse was advised by her attorney that the "new arrangement" would in no way affect the present crediting of her account "with a sum equal to the total rent from the property."

Before respondent's incorporation the rental income from The Fair was transmitted to the Bank of Montreal, New York, which credited the funds to Mrs. Whitehouse's account as trustee. After respondent was incorporated, The Fair made its checks payable to respondent. But pursuant to a duly authorized resolution of respondent, The Fair caused the checks to be transmitted to the Bank of Montreal and credited directly to Mrs. Whitehouse's account, as had been done previously. Upon the death of Mrs. Whitehouse in 1944, the stock in respondent and the note became the property of her six children, but the general collection process continued substantially as before. The Bank received the rentals and forwarded them directly to the accounts of the shareholders. Since the interest payments were intended to exhaust the rental income, appropriate corporate action was taken to refund the debt by notes at a higher interest rate when, under the terms of the lease, the rental income increased. At times the amount paid out as interest exceeded the amount due on the notes.

The lease under which these rental payments were made was a "net lease," under which all the usual duties of ownership and management were imposed upon the lessee. Respondent, organized to hold the title to the land and the lease, did not engage in general activities unconnected with this purpose. Thus it did not maintain an office (other than the required Illinois statutory office) for the transaction of business. It had no bank account. Its mailing address was at all times in care of the attorneys for the Whitehouse family. It had no expenses except for the service fee charged by the Bank of Montreal, small legal fees paid to the family attorneys, and Illinois franchise taxes. Its only source of income was the rental checks which, after payment of the above expenses, were distributed by the Bank directly to the shareholders, as stated above.

Hence consistent with its purpose the only activities required of respondent were such as at once to preserve its existence and to provide for collection of the rent and its distribution to the shareholders. So at all times it executed the necessary documents to this end with the required corporate formalities. It held a stockholders' meeting in 1933 for the purpose of organization and election of directors, and another in 1947 for ratification of the lease by the then stockholders as requested by counsel for the lessee, The Fair. It held some ten directors' meetings, the directors and officers consisting of certain trust beneficiaries who served without compensation and of the family attorneys who were compensated for their legal services. Minutes were kept of these meetings; and these showed choice of new directors to fill vacancies, modifications in some details as to the payment

instructions on transfer of a note by the holder to her children, and refunding of the notes at a higher interest rate as the lease rental increased. In 1935 respondent was dissolved by the Superior Court of Illinois for failure to pay franchise taxes, but the dissolution decree was vacated in 1938 when the attorneys learned of it and paid the delinquent taxes. Respondent filed income tax returns as above stated and has carried on the present proceedings in the Tax Court and here in its corporate name. There can be no question but that respondent is and has been a valid corporation under state law.

Respondent asserts, however, that the question whether it was a bona fide corporation under state law is not dispositive of the question whether it should be recognized as a corporation for federal income tax purposes. We are referred to Moline Properties v. C. I. R., 319 U.S. 436, 439, 63 S.Ct. 1132, 1134, 87 L.Ed. 1499, where the Supreme Court stated that a corporation will be treated as a separate taxable entity so long as the purpose of incorporation "is the equivalent of business activity or is followed by the carrying on of business by the corporation." In National Investors Corp. v. Hoey, 2 Cir., 144 F.2d 466, 468, this Court, per L. Hand, J., took this statement to mean "that to be a separate jural person for purposes of taxation, a corporation must engage in some industrial, commercial, or other activity besides avoiding taxation: in other words, that the term 'corporation' will be interpreted to mean a corporation which does some 'business' in the ordinary meaning; and that escaping taxation is not 'business' in the ordinary meaning." It may be noted that in both cases decision went against the taxpayer.

We think that respondent, having full beneficial ownership of the land and collecting the rent therefrom, en-

gaged in business under the principles above enunciated. This is not a case where the corporation was a mere nominee, powerless to act with respect to the land other than with consent of the beneficial owners. Had the corporate officers and directors determined to sell the land, or to reinvest in other property, the shareholders who had been receiving the rent could not have complained. This is not a case where income belonging to the shareholders was received in form by the corporation. The income belonged to the corporation, and was paid directly to the shareholders only because this suited the purpose for which the corporation had been established. Thus the corporation was organized for a specific purpose which required for its fulfillment a separate legal entity, more than a sham or "shell"; and over the years it carefully satisfied every legal requirement to achieve its purpose.

Respondent relies chiefly on Paymer v. C. I. R., 2 Cir., 150 F.2d 334, 336, where this Court, at the instance of the taxpayer, disregarded the separate existence of a corporation created to hold title to real estate. There title to certain real estate was conveyed by a partnership to the Westrich Realty Corp. for the purpose of concealing the true ownership from creditors. The conveyance was made "with the express understanding that the corporation is only to hold title to the property, the beneficial interest and profits to be in the individual stockholders and the management and control of the property exclusively theirs." No attempt was made even to assign the leases existing on the real estate to the corporation. Here respondent was the complete beneficial owner of the property and the lease. The difference between respondent and Westrich is the

difference between a beneficial owner of income-producing property and a mere nominee for furnishing a name for the land records. In reality Paymer is nothing more than a restatement of the fundamental rule that income from real estate held in the name of a nominee will be taxed to the beneficial owner, not to the nominee.[1] We do not understand United States v. Brager Bldg. & Land Corp., 4 Cir., 124 F.2d 349, to involve anything more than another application of this rule.

O'Neill v. C. I. R., 2 Cir., 170 F.2d 596, certiorari denied 336 U.S. 937, 69 S.Ct. 747, 93 L.Ed. 1096, does not hold to the contrary. There an individual taxpayer created two wholly owned corporations to hold title to real estate, so that the taxpayer could deal with it without requiring his wife's signature on deeds or other documents. The corporations received some rent, and some proceeds from sale of real estate. This Court there held that the corporation was not sufficiently distinct an entity from its sole shareholder to permit advances made by the shareholder to the corporation to be treated as debts. But the corporate entity was not disregarded, because the advances were given effect as capital contributions. The question whether a corporation is to be treated as a separate taxable entity is distinct from the question whether advances made by a shareholder to that separate entity are loans or capital contributions. Nor is Jackson v. C. I. R., 2 Cir., 233 F.2d 289, in point. That case involved intermediate corporations in a holding company structure—a problem

1 It is significant that in the Paymer case the court held another similar holding company, Raymep Realty Corp., Inc., taxable as a corporation because it had made a single loan, assigning its lease rights as security. While respondent stresses the absence of such circumstance here, it is obvious that this is without significance here where the corporation had no need or use of a loan to fulfill its corporate purpose.

not here present. The instant case would be analogous to Jackson only if the shareholders of respondent formed a new corporation and transferred their stock and notes in respondent to that new corporation in exchange for its stock. The new corporation would then be comparable to the Belgrade corporation in the Jackson case.

Furthermore, it is to be noted that in Jackson, as in O'Neill and most of the other cases cited, the corporate entity was disregarded at the instance of the Commissioner. As is shown by this Court's decision in Gregg Co. of Del. v. C. I. R., 2 Cir., 239 F.2d 498, certiorari denied 353 U.S. 946, 77 S.Ct. 825, 1 L.Ed.2d 856, made soon after Jackson, the Commissioner, to prevent unfair tax avoidance, has greater freedom and responsibility to disregard the corporate entity than a taxpayer, who normally cannot be heard to complain that a corporation which he has created, and which has served his purpose well, is a sham. In the Gregg case, taxpayer was a subsidiary of a New York corporation whose business operations were conducted wholly outside the United States. The parent, to eliminate the United States corporate tax on these foreign operations, decided to form a corporation in the Republic of Panama to carry on the foreign operations. In a tax-free reorganization the parent transferred its operating assets to the taxpayer in exchange for all the taxpayer's stock. The taxpayer then transferred these assets to the Panama corporation in exchange for preferred stock. Thus the taxpayer was an intermediate holding company not substantially different from the Belgrade corporation in Jackson. In Jackson the Commissioner was permitted to disregard Belgrade's corporate existence, even though that existence served the taxpayer's

purpose of segregating out for the wife, as sole shareholder of Belgrade, all future profits. But in Gregg, 2 Cir., 239 F.2d 498, 502, when the taxpayer argued that its separate existence should be disregarded because it was a "mere conduit to receive dividends," and therefore was not engaged in business activity, this Court stated: "The petitioner was originally formed in order to effectuate a tax-free reorganization, the purpose of which was found by the Tax Court to be the elimination of a corporate tax on the foreign profits of the Gregg operations. The reorganization was accomplished, and the petitioner served continuously as a holding company from that date forward, reporting as its corporate income the dividends it received from the corporate stock it held. Thus the petitioner has performed the functions for which it was created, and those functions are sufficient to constitute a 'business activity' for purposes of taxation."

Hence we conclude that respondent has performed the functions for which it was created, and these functions are sufficient to constitute a business activity for purposes of taxation. Higgins v. Smith, 308 U.S. 473, 477, 60 S.Ct. 355, 84 L.Ed. 406.[2] It follows that the decision of the Tax Court must be reversed and the proceedings remanded to that court for the assessment of deficiencies. It is so ordered.

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2. When Congress has desired to give taxpayers the benefit of using the corporate form without paying a corporate income tax, it has known how to do so specifically and directly. Compare the election as to their taxable status given "certain small business corporations" by I.R.C. 1954, subchapter S, §§ 1371–77, added by Pub.L. 85–866, Tit. I, § 64(a), Sept. 2, 1958, 72 Stat. 1650

Judgment of the United States Court of Appeals for the Second Circuit.

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the thirty-first day of October, one thousand nine hundred and sixty.

Present—Hon. CHARLES E. CLARK,
Hon. CALVERT MAGRUDER,
Hon. HENRY J. FRIENDLY, Circuit Judges.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

STATE-ADAMS CORPORATION,
Respondent.

Appeals from The Tax Court of the United States

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is reversed and that the action be and it hereby is remanded for the assessment of deficiencies in accordance with the opinion of this court.

A. DANIEL FUSARO
Clerk